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SANTO DOMINGO FOR FCS AND FAS

TREASURY FOR L LAMONICA

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SUBJECT: GOJ'S FISCAL PROGRAM OFF TRACK

SENSITIVE BUT UNCLASSIFIED

11. (SBU) Summary: Data released by the Ministry of Finance on September 30 showed that the GOJ's fiscal deficit of USD 290 million continued to run ahead of the GOJ'S target of USD 270 million. The deficit overrun was primarily due to lackluster revenue generation, reflecting a slump in consumption taxes. To curtail the fiscal downturn, the GOJ slashed overall expenditures by curbing spending on capital projects and recurrent programs such as utilities and social programs. To finance the deficit and amortize debt, over USD 1 billion was sourced from the capital markets, pushing the national debt to USD 13 billion. The government, already faced with the Herculean task of meeting its balanced budget objective, will encounter even greater challenges given its recent decision to grant public sector workers a hardship allowance. The fiscal authorities will therefore have to find creative ways to increase compliance and broaden the tax base, as any major deviation from the balanced budget objective could upset the capital markets. End summary.

12. (SBU) Data released by the Ministry of Finance on September 30 revealed that GOJ operations generated a deficit of USD 290 million during the first five months of this fiscal year (April to August 2005). This represents an approximately USD 20 million departure from budget forecasts and marks the continuation of a trend observed since April. Poor revenue inflow, due largely to a slump in consumption, was the main reason for the deviation in the deficit. Revenue collections of USD 1.1 billion were USD 83 million below the USD 1.2 billion budgeted for April to August. During the period, General Consumption Taxes (GCT) amounted to USD 302 million or USD 60 million less than projected. Keith Collister of the Jamaica Chamber of Commerce told emboff that the underperformance of GCT was particularly striking as it occurred within the context of a 1.5 percentage point increase in the rate to 16.5 percent in April 2005.

13. (SBU) However, Senior Fiscal Economist at the Ministry of Finance, Courtney Williams, told emboff that he was not surprised by the underperformance in taxes, as the target was overly optimistic. Williams said that while data were not yet available, anecdotal evidence suggests that most individuals had curtailed spending due to flat wages and double-digit inflation. He said inflation-based revenues were not a factor, as inflation was being fuelled by oil, which has a flat tax rate, and food, which does not attract taxes. Williams said gas consumption had also fallen by at least two percent since the start of the fiscal year. The falloff in revenues was also partly due to the sluggishness in the Jamaican economy, which is still recovering from the effects of three hurricanes in under a year. Despite the downturn in overall revenues, there was a 26 percent increase in actual profit taxes over projection, reflecting the significant increase in the profits of large publicly-listed financial companies such as the Bank of Nova Scotia.

14. (SBU) The falloff in revenues forced the GOJ to chop spending by USD 62.6 million to contain the expansion in the fiscal deficit. Total expenditures for the period amounted to USD 1.39 billion compared to a budget of USD 1.45 billion. While the contraction in expenditures was widespread, the fiscal restraint was most evident in capital spending and programs (utilities, social programs and day-to-day spending). Capital expenditures of USD 102 million were slashed by 23.3 percent from projections of USD 125 million, while programs were cut by 9.8 percent to USD 264 million. The GOJ'S decision to cut the capital budget following three hurricanes will lead to further deterioration of the island's physical infrastructure in general and roads in particular. The reduction in spending on programs will also lower the benefits to the most vulnerable groups, already buckling under the high

prices. Collister pointed out that the notable exception in the expenditure restraint was the spending on domestic debt payment, which was USD 4.1 million above target. He said the overshoot could suggest that the interest rate reduction program was now running behind target, reflecting inflation that was higher than anticipated. Collister said the GOJ should therefore consider borrowing more funds internationally, substituting cheaper external financing for higher domestic borrowing.

15. To finance the fiscal deficit and to amortize debt, the GOJ had to source USD 66 million from the capital markets. This brought the total amount of debt contracted for the five-month period to USD 1.1 billion and the national debt to USD 13 billion. While most of the borrowing came from the domestic market, the GOJ also issued a ten-year USD 300 million eurobond with a coupon on nine percent per year. This is the lowest rate Jamaica has raised funds on the international capital market and occurred amidst rising US interest rates and at a time when investors are shunning emerging market debt. This suggests that external investors continue to have a high level of confidence in Jamaica's ability to repay debt, notwithstanding the macroeconomic challenges. The country's continued generation of high primary surpluses (revenues minus non-debt spending), a measure of debt sustainability, would also have buoyed investor's appetite for Jamaican bonds.

COMMENT

16. **Fiscal Outlook:** The GOJ will be hard pressed to balance the 2005/06 fiscal budget, particularly given its recent decision to grant all public sector workers a hardship allowance - amounting to approximately USD 16 million - to alleviate the pressure being caused by the wage restraint. This combined with the increasing cost of providing public goods and services will make further expenditure restraint difficult in upcoming months. Domestic interest payments could also continue to outstrip projections, as the Bank of Jamaica (BOJ) has halted its interest rate reduction program due to higher than anticipated inflation. Revenue collections could also remain moribund for the remainder of the fiscal year due to the sluggish economic conditions and waning business and consumer confidence. The fiscal authorities will therefore have to find creative ways to increase compliance and broaden the tax base in order to bring revenue collections in line with projections, as any deviation from the balanced budget objective will be viewed with disfavor by an expectant capital market. In particular, the country would have to pay higher rates of interest to borrow from both the local and international capital markets in 2006. End outlook.

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